B. All Remaining Implicit Cross-Subsidies, Such As Retail, Billing And Collection, And Equal Access Expenses, Must Also Be Removed From Price Caps.

The modifications to the Commission's Part 69 rules described in the previous section will remove many of the implicit cross subsidies that are currently built into the LECs' access charges. However, some such implicit subsidies will remain even after those modifications. These subsidies should also be eliminated, either directly (for example, through adjustments to the appropriate cost allocation rules) or indirectly, through appropriate adjustments to the price caps, or both.

1. **Retail Expense.** One improper implicit subsidy is the retail expense currently included in carrier interstate switched access charges. Access is a wholesale service, not a retail service. It is therefore inappropriate, on cost-causation grounds, to include costs associated with retail functions in access charges.

However, as shown in detail in Appendix D, approximately $575 million in direct retail expenses (including marketing and customer service costs) are currently included in those charges. Some $265 million in indirect retail expenses (including general support, corporate operations, and uncollectible revenue) are also included.[105] Thus, solely by virtue of this misallocation of retail costs, access services are currently priced some $840 million annually above their true economic cost.

This is inappropriate for at least three reasons. First, it violates the 1996 Act. Section 252(d)(3) of the Act states that wholesale rates will be determined "on the basis of retail rates

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[105] These calculations are in accordance with the Commission's recent order on this subject. *Local Competition Order* ¶¶ 917-18.

charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."[106] Thus, if they are to comply with the Act, access charges must not be priced to recover retail costs.

Second, inclusion of retail costs in access charges violates the fundamental principle that services should be priced at their long-run incremental cost. The violation of this principle, moreover, currently results in an enormous cross-subsidy flowing from access charges to other services.

Third, inclusion of retail costs violates the cost-causation principles discussed in the preceding section. As a matter of economic efficiency, retail costs should be borne by those who cause them, namely, retail customers. Forcing wholesale customers to bear a portion of those costs merely encourages over-use of retail services, and under-use of wholesale services such as access.

2. Billing and Collection Costs. The Commission likewise must take steps to ensure that price caps do not allow the ILECs to recover in access charges the costs caused by the LECs' detariffed billing and collection functions, including those arising from use of general support facilities ("GSF") and computer costs in providing those functions.

Under the current Part 69 rules, no GSF investment is assigned to the Billing and Collection category, even though GSF assets are used extensively in the LECs' billing and collection operations. As shown in Appendix E, AT&T estimates that, as a result,

[106] 47 U.S.C. § 252(d)(3).

approximately \$124 million of GSF-related revenue requirements properly supporting detariffed billing and collection are now improperly assigned to the access rate elements.

These errors crept into the system as a result of a 1987 Commission Order in Docket No. 87-113.[107] The Commission can and should correct these errors now, as part of its overall reform of access charges.

3. **Equal Access Conversion Costs.** The Commission also seeks comment on whether price cap ILECs should be required to make a downward exogenous adjustment to their PCIs to account for the completion of the amortization of equal access network reconfiguration costs on December 31, 1993. NPRM ¶ 293. Plainly, yes. As the Commission recognizes, although the ILECs have fully recovered the expenses related to equal access conversion and the corresponding rate elements have been removed, their price cap indices remain improperly inflated because they have not yet been reduced to reflect this fact. As the Commission resolved in the LEC Price Cap Order, 5 FCC Rcd. at 6808, expiration of amortizations should result in downward adjustments to the price caps because "it would be unfair to ratepayers who are now bearing the cost of the amortization program if rates were not adjusted downward at the end of the program."[108] Failure to make this

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[107] See Amendment of Part 69 of the Commission's Rules and Regulations, Access Charges, 2 FCC Rcd. 6447 (1987); see Petition Partial Reconsideration of AT&T, filed October 27, 1987.

[108] See also LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637, 2673-74 (1991) aff'd sub nom. National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

downward adjustment results in an implicit subsidy in excess of $110 million per year for the RBOCs alone.[109]

For these reasons, retail costs, billing and collection expenses, and equal access conversion costs should be removed from access charges. The same is true of any other implicit subsidies remaining after the modifications to the Commission's Part 69 rate structure rules discussed in Section IV.

C. The X-Factor Should Be Substantially Increased To Ensure That Access Rates Remain Just And Reasonable.

All of the above-mentioned changes will only help to ensure that access charges are reduced to their *current* long-run incremental costs. Obviously, however, improvements in productivity -- in the economy generally and in the industry -- will further reduce long-run incremental costs over time. And that is the very reason the Commission has included a productivity offset or "X-Factor" in its calculation of LEC price caps.

In theory, it is this X-Factor (along with offsets for inflation and other exogenous factors) that ensures that price caps remain at long-run incremental costs, once they have been calibrated at that level. This, in turn, ensures that "ongoing gains by the LECs in reducing unit costs are passed through to customers."[110] Thus, even if price caps applicable to access services are now calibrated at long-run incremental cost (as calculated under a TSLRIC or

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[109] See Appendix F.

[110] Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1, 10 FCC Rcd. 13659 ¶ 16 (1995).

TELRIC methodology), it is essential that the X-Factor also be adjusted to reflect likely productivity growth.

As AT&T has explained at length in its comments in Docket 94-1, the current minimum X-Factor of 4.0 percent is far too low, and therefore confers an ever-burgeoning windfall on the LECs.[111] Further, as AT&T has also demonstrated, a minimum X-Factor of approximately 8.8 percent (assuming a 0.5 consumer productivity dividend) would more accurately reflect the LECs' likely productivity growth, and is therefore needed to ensure that the price cap system, even after being properly calibrated, keeps access charges in line with changes in the LECs' long-run incremental costs.[112]

These calculations, moreover, are correct even if one assumes that the LECs are forced in this proceeding to reduce their access charges to current long-run incremental costs (as measured by TSLRIC or TELRIC), and if the other changes discussed above are made. In fact, at least two factors suggest the LECs' real productivity growth will be even higher than 8.8 percent if those changes occur.

First, removing subscriber lines (and associated SLCs) from price caps, as AT&T proposes, will mean that the LECs' price capped revenues will no longer come from subscriber lines. Instead, those revenues will come entirely from transmission, switching, and signaling

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[111] Comments of AT&T, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, at 1-30 (filed Jan. 11, 1996); Reply Comments of AT&T at 1-35 (filed March 1, 1996).

[112] If a LEC is not required to share excess earnings with ratepayers, the X-Factor should be increased to 9.8 percent. See Ex Parte Letter from B. W. Masterson, AT&T to W. F. Caton, FCC, dated April 5, 1996, in CC Docket No. 94-1.

functions that tend to benefit the most from productivity growth and lower input prices. This would imply an even higher X-Factor than the 8.8 percent discussed above.

Second, if access prices were set at long-run incremental costs, the resulting price reduction would likely stimulate a great deal of additional demand for access. The higher growth in calling volumes would result in greater productivity growth during that period, thereby justifying an even higher X-Factor.

The improved productivity growth associated with increased demand and the exclusion of subscriber lines from price caps should more than offset any other factors (if there are any) that might tend to reduce productivity growth, at least for the next several years until the next price cap review. There is thus no reason to think that reducing access prices to TELRIC levels would justify adoption of a lower X-Factor than that AT&T proposed in Docket 94-1.

In short, only if the price cap regime is reformed along the lines suggested above can it ensure, not only that access rates are set at the LECs' current long-run incremental cost, but also that those rates continue to decline with declining costs. Only then will the Commission's regulation of access prices satisfy the "just and reasonable" standard.

VI. THE DISTORTIONS CREATED BY THE ENHANCED SERVICE PROVIDER EXEMPTION MUST BE ADDRESSED PROMPTLY TOGETHER WITH ACCESS REFORM.

AT&T has not sought to eliminate the exemption that enhanced service providers ("ESPs") enjoy from payment of switched access charges, *while* interstate access rates are neither cost-based nor have efficient rate structures. As discussed in the preceding sections, the only effective solution to the existing access charge problem is for the Commission to require that switched access rates be set at forward-looking economic cost and the rate structures be revised to be cost-causative.

If access is priced at TELRIC and the rate structures reflect the manner in which costs are incurred, there will no longer be any need or basis to continue the ESP exemption. NPRM ¶¶ 284, 288. Indeed, AT&T submits that if the Commission does not act quickly to reform access, it must nonetheless act promptly to halt the serious market distortions that result from the fact that ESPs, unlike other users of the LECs' networks, have not been required to pay the costs associated with their use. Among other things, these distortions skew artificially the technology choices made by suppliers (and customers), because the exemption favors one technology over another notwithstanding that they make equivalent use of LEC facilities and functions.

VII. ILECS SHOULD BE GRANTED ONLY LIMITED PRICING FLEXIBILITY PRIOR TO THE EMERGENCE OF SUBSTANTIAL COMPETITION.

Finally, regardless which approach the Commission adopts, it should grant ILECs only limited pricing flexibility prior to the actual emergence of substantial competition. In this proceeding, the Commission has undertaken the long overdue task of reforming the current, inefficient exchange access regime. Undoubtably, significant revisions to current rate structures, price cap levels, and, potentially, access rates will emerge. By prematurely removing the regulatory constraints identified in the NPRM (¶¶ 163-217), however, any significant strides toward lower consumer prices, higher quality service, and increased competition will be eviscerated. For example, granting ILECs pricing flexibility before substantial competition has taken hold will result in supracompetitive access charges. Similarly, any modifications to the current rate structures will become meaningless if the incumbent carriers can assess access charges in any manner of their choosing. The dangers of increased regulatory flexibility are particularly egregious if price caps have not been reduced to efficient levels because the persistence of excess revenues in one service or market will permit subsidization of any other service or market served by the ILEC anywhere in its geographic region. Clearly, then, the Commission must maintain many of the existing regulatory limitations that minimize cross-subsidization and control the monopolistic fees the ILECs would otherwise impose on IXCs and, ultimately, consumers.

The Commission has long recognized the need to constrain a monopolist's ability to subsidize competitive services with excess revenues from monopoly markets. In fact, the potential for such anticompetitive tactics underlies much of the current price cap structure.[113] The 1996 Act has not magically made monopoly local exchange or exchange access markets competitive. To the contrary, it has, at least temporarily, increased the ability and incentives of ILECs to engage in abusive practices.

First, the prospect of increased ILEC long distance entry increases the ILEC's opportunities to leverage exchange access bottlenecks into otherwise competitive long distance markets. For example, if Ameritech demonstrates that substantial competition has emerged in Chicago, the Commission proposes to deregulate exchange access services in that area.

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[113] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd. 6786 ¶ 19 (1990).

Ameritech will, however, still operate in other regions where competition remains minimal or nonexistent. Because the market-based approach would permit Ameritech to continue earning supracompetitive profits in those regulated markets, it could use those excess earnings to subsidize predatory pricing in Chicago. Ameritech could thereby not only drive more efficient rivals from the market, but also discourage entry in markets where this anticompetitive potential exists. The MFJ previously foreclosed these markets to the BOCs precisely because of their ability to extend their local monopolies into long distance services. While the Act has attempted to mitigate this danger by beginning the process of opening up the local markets to competition, the Commission must not make the mistake of equating the mere possibility of effective competition in the future with actual competition sufficient to constrain ILEC pricing behavior.[114] As demonstrated in Sections II and III, above, there is little reason to expect emerging local competition to vitiate ILECs' exchange access dominance in the next few years. Thus, absent current price cap limitations, ILECs can and will remain free to subsidize competitive markets with excess revenues from noncompetitive ones.

Second, increased regulatory flexibility will also permit cross-subsidization within the same market. For example, if the Commission permits differential pricing across classes of end-users, the persistence of above-cost access rates could allow an ILEC to provide business

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[114] Indeed, the Commission has already acknowledged that preventing cross-subsidization is mandated by the Act and necessary to protect consumers. See Accounting Safeguards Order ¶ 24 ("We affirm that protecting ratepayers from cross-subsidizing competitive ventures is a primary goal."); id., ¶ 73 ("We conclude that section 254(k) bars all incumbent local exchange carriers, including BOCs, from subsidizing competitive interLATA telecommunications services . . . with revenues from exchange service and exchange access that are not subject to competition")

customers with a bundle of local, exchange access, and long distance services at a rate that could not be matched by an equally or more efficient competitor. This is just one of the numerous cross-subsidy opportunities that would not have been available to the RBOCs or GTE before the passage of the Act, but which would become part of many ILECs' arsenals if the Commission prematurely relaxes regulatory restrictions.

In light of these realities, the tests proposed for each phase of expanded regulatory flexibility are entirely inadequate. At Phase 1, the Commission need only find that there exists the potential for competition. NPRM ¶ 168. Indeed, no more is required than the existence of an interconnection agreement that conforms to the Commission's *Local Competition Order*.[115] Nevertheless, the Commission proposes to initiate substantial deregulation of exchange access services with no further showing that market forces will constrain the ILECs' anticompetitive behavior as well as excessive access prices. This is arbitrary and unreasonable.

Phase 2 purports to require "the establishment of an actual competitive presence." NPRM ¶ 201. Yet the Commission suggests only three vague "criteria" for determining whether or not this rung on the "competitive" ladder has been attained. First, there must be a demonstrated "competitive presence." Id.¶ 202. Second, the ILEC must have fully

[115] The conditions for satisfying the Phase 1 trigger are: 1) unbundled network elements must be available at TELRIC rates; 2) transport and termination must be available for local traffic at cost-based rates; 3) retail services must be available to resellers at a discount based on reasonably avoidable cost; 4) a demonstration that competitors can actually order and receive elements and services in a reasonable fashion and amount of time; 5) dialing parity and number portability must be provided; 6) access to rights-of-way; and, 7) network standards must be open and nondiscriminatory. NPRM ¶¶ 170, 173-76.

implemented "competitively neutral universal service support mechanisms."[116] Id. Third, there must be "credible and timely enforcement of pro-competitive rules." Id. This ill-defined and amorphous standard can only produce premature and competitively destructive flexibility, because it does not require the kind of extensive competition that could effectively constrain ILEC pricing conduct.

The proposed standards also represent an unexplained departure from past Commission deregulatory policy. AT&T, for example, remained subject to substantial price regulation for over ten years despite its perpetually decreasing market share.[117] In support of its decision to release AT&T from the price cap system, the Commission cited numerous factors indicating AT&T's inability to set market prices, including the existence of "intense rivalry," the presence of at least two national facilities-based competitors plus hundreds of other carriers that employ facilities or resale or both to provide service to customers, and AT&T's lack of control over "bottleneck facilities for over ten years."[118] ILECs, on the other hand, will continue to control bottleneck facilities into the foreseeable future, and will maintain price setting powers even once the Phase 1 and Phase 2 criteria have been met. The only way to avoid these harms is to equate a demonstrated competitive presence with substantial actual

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[116] This criterion requires action principally by the Commission, not the ILEC.

[117] Motion of AT&T Corp. To Be Reclassified As A Non-Dominant Carrier, 11 FCC Rcd 3271, ¶ 41 (1995).

[118] Id. ¶¶ 70, 72.

competition, thereby better assuring that market forces will provide an adequate restriction on ILEC pricing behavior.

The remainder of this section develops these points in more detail. Subsection A explains why the Commission should make clear, *now*, that it will not implement any of the Phase 1 or Phase 2 proposals prior to the emergence of substantial, actual competition. Subsection B explains why the Commission should, in the interim, undertake a separate rulemaking to put in place the criteria by which to determine whether competition is sufficiently well advanced to permit such flexibility in the future.

A. Prior To The Emergence Of Substantial Competition, The Commission Should Not Implement Any Of The Phase 1 and Phase 2 Flexibility Proposals.

The Commission (NPRM ¶¶ 163-217) has asked for comments on several proposed flexibility enhancements to the current regulatory regime, including geographic deaveraging, allowing ILECs to offer new services outside of price cap regulation, eliminating price cap service categories within baskets, allowing differential pricing across customer classes, eliminating rate structure rules for the transport and local switching elements, and consolidating the traffic-sensitive and trunking baskets.[119] As described earlier, the Act actually increases the potential harm from increased regulatory flexibility absent substantial, pervasive, widespread competition in an ILEC's geographical market. These individual

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[119] AT&T's Comments (filed December 11, 1995) and Reply Comments (filed February 6, 1996) in the Price Cap Performance Review for Local Exchange Carriers proceeding, CC Docket No. 94-1, are attached as Appendices G and H respectively. They address in greater detail many of the concerns raised infra regarding the Commission's pricing flexibility proposals as well as some additional risks not identified in these Comments.

proposals all pose a similar risk. Although local competition will hopefully eventually end the need for these regulatory safeguards, that day still lies in the distant future. In the meantime, the Commission cannot abandon its established policy that these restrictions are necessary to prohibit cross-subsidization, predatory practices, and other unreasonable anticompetitive conduct.[120]

Although the fundamental flaw in each of the NPRM's proposals is essentially the same, each one is briefly addressed below. In each case, the ILEC would have an additional opportunity to cross-subsidize competitive services from noncompetitive ones, and simultaneously entrench itself in the local market as well as gain a strategic advantage in long distance markets.

1. **Geographic Deaveraging**. (NPRM ¶¶ 180-86) As discussed above, it is clear that functionally equivalent elements employed in providing local exchange and exchange access services should be priced the same. State commissions have generally not found a cost-

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[120] Possibly the most persuasive advocate on why restrictions should remain is the Commission itself:

> "Some parties have sought to equate pricing flexibility with the ability to engage in predation against the newly formed alternative access industry, or to engage in cross-subsidization to the detriment of particular classes of customers. We believe that the limited amount of pricing flexibility available to LECs under our incentive regulation plan will not grant a license to LECs to engage in predation or cross-subsidization. . . . [S]egregating LEC access services into four baskets defeats any LEC attempts to finance a predatory rate level by contemporaneously increasing rates for other services."

Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd. 6786 ¶ 36 (1990).

basis for deaveraging access-related, unbundled elements such as switching and transport because, unlike the loop, the costs generally do not depend upon the area in which they are deployed.[121] Therefore, unless the states find some cost-based justification for geographic deaveraging, the Commission should not permit any further deaveraging of equivalent exchange access elements lest it create undesirable arbitrage opportunities that would distort customer usage and investment decisions.

More importantly, additional geographic deaveraging would allow the incumbent monopolists to employ anticompetitive tactics -- specifically, cross-subsidization -- in markets where competition might otherwise provide exchange access pricing discipline. Competition will, most likely, emerge initially in high density zones. Without limitations on geographic deaveraging, ILECs could, therefore, cross-subsidize the rates charged in high-density zones by increasing (or refusing to make appropriate reductions to) rates in low-density zones. Geographic averaging reduces the likelihood of such behavior. It also allows rural customers to enjoy the price reductions engendered by new entrants in other market segments.

Finally, exchange access rate deaveraging cannot be reconciled with § 254(g) of the Act which requires interexchange rate averaging.[122] Under deaveraged access rates, ILEC long distance affiliates would enjoy a tremendous cost advantage because they could enter the high density zones exclusively and easily undercut the national IXCs' nationwide averaged rates.

[121] While the Commission decided to allow zone density pricing for transport, it did not actually conduct a formal cost study; rather it relied mostly on the unexamined premise that transport in higher density zones should be less expensive.

[122] 47 U.S.C. § 254(g).

As a result, rural customers would not enjoy the added benefits of competition in other density areas that Congress intended to promote through § 254(g). Indeed, some national IXCs may find it necessary to stop serving these areas altogether in order to remain competitive in the more lucrative, low-cost regions of the country. Further deaveraging of exchange access rates, then, will provide ILECs with an unjustifiable strategic advantage in addition to contravening the Act's intent and effect.

2. Additional Volume And Term Discounts. (NPRM ¶¶ 187-92) Additional volume and term discounts should also not be allowed until actual competition develops. The Commission has previously identified instances, such as special access, where these discounts reflect true costs savings. NPRM ¶ 187. In general, however, the Commission has correctly maintained that volume and term discounts are a substantial departure from past practice and should be considered with great caution.[123] The dangers of expanding the current exceptions to this general prohibition are readily apparent.

First, except in those unique cases where the ILEC has demonstrated by clear and convincing evidence that a volume discount is cost justified, the Commission runs the risk of allowing the incumbent monopolist to undercut its competitors through cross-subsidization from noncompetitive areas. If a potential entrant faces this kind of discrimination, it may simply choose to remain out of the market altogether.

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[123] Expanded Interconnection with Local Telephone Company Facilities, 9 FCC Rcd. 5154, 5204 (¶ 183) (1994).

Second, additional term discount authority offers ILECs the opportunity to lock customers into long duration contracts that reflect current high access rates, thereby foreclosing the benefits of future competition to those customers. Although the Act is intended to promote the rapid introduction of competition, allowing term discounts prior to the emergence of substantial competition can create a significant barrier to entry that at best will delay entry unnecessarily. Additional volume and term discounts thus contravene the Commission's goal of rapidly encouraging competition as a permanent solution to regulation of exchange access services.[124]

3. New Services Outside Of Price Cap Regulation. (NPRM ¶¶ 197-200) The Commission also should not deregulate new services. The Third Report and Order in Docket No. 94-1 (¶¶ 309-10) has already greatly enhanced ILEC pricing and tariff flexibility. ILECs no longer need file a Part 69 Waiver Request to introduce a new switched access service that does not conform to Part 69 rate structure requirements, and subsequent ILECs do not even have to meet the public interest criteria once the initial applicant has satisfied this requirement. Coupled with other simplifications, ILECs have more than sufficient flexibility to introduce new services.

It is imperative, however, that no further deregulation occur because of two risks presented by the provision of access services outside of price cap regulation. First, such a policy would provide additional opportunities for ILEC affiliates, and potentially some

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[124] AT&T concurs with the Commission's tentative conclusion that growth discounts would disadvantage IXCs and provide an unfair competitive advantage to ILECs' long distance affiliates. NPRM ¶ 192.

nonaffiliates as well, to obtain exchange access on a discriminatory basis. The ILEC, for example, may be able to repackage what are essentially the same services offered to other customers into a "new" service, offered at a discount, but available (because of service restrictions, etc.) only to the LEC affiliate or other favored carrier.

Second, deregulation of new access services could force carriers, particularly IXCs who are dependent on those services, to pay monopolistic rates. Current price cap requirements provide a mechanism for ensuring that rates are neither too high nor too low.[125] They also permit the Commission to disallow rates structures that disadvantage other carriers. Absent these safeguards, IXCs must resort to the complaint process or antitrust proceedings which, although they may ultimately provide some relief, require a long time to complete.[126]

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[125] Cost support is essential to determine whether or not an ILEC is pricing its services in an unreasonably or unjustly discriminatory fashion. Even a direct cost showing could only demonstrate that a LEC is not pricing a new service predatorily; it does not guard against a LEC pricing a monopoly service too high. Thus, anything less than the current cost showing requirements, including ILEC justification of overhead allocations, would invite discrimination and excessive rates.

[126] During the pendency of such an action, moreover, an ILEC could continue to extend preferential, discriminatory treatment to its long distance affiliate or certain nonaffiliated carriers of its choosing, as well as strong-arm dependent carriers into paying unjust and unreasonable rates. For example, the operating company could offer a new access service that has a very large nonrecurring cost, but a very small per minute switching charge. The ILEC's long distance affiliate could pay the nonrecurring fee -- it is merely relocated to another branch of the holding company -- and then incur a very low recurring charge. An IXC, on the other hand, may find the high nonrecurring charge prohibitive and, therefore, continue to operate under a pre-existing service at a higher access cost. In this and similar ways, the incumbent carriers could use their new services to gain a competitive advantage over entrants.

In sum, the Commission should delay additional new service flexibility until competition has sufficiently emerged to prevent these kinds of discriminatory, unreasonable, and anticompetitive tactics. As the Commission only recently concluded, the "record in this proceeding does not support a finding that competition for LEC services is sufficiently widespread to constrain the pricing practices of LECs for new services. Accordingly, the Commission will continue to review new services tariff filings for possible discrimination."[127] It should not now abandon this well-reasoned policy.

4. **Price Cap Service Categories Within Baskets, Rate Structure Rules For The Transport And Local Switching Elements, And Traffic-Sensitive And Trunking Baskets.** (NPRM ¶¶ 211, 214-17) Further changes to the price cap basket structure should also be deferred pending the development of substantial, demonstrated competition and careful examination of whether the proposed modifications would protect ratepayer interests. When the Commission constructed the pricing baskets, it intended to minimize ILEC incentives "to shift costs between baskets, because changes in prices within one basket do not affect prices in the others."[128] The baskets and price cap bands were designed not only to "replicate the effect of competition" in the exchange market,[129] but also to protect consumers.[130] Changes

[127] Price Cap Performance Review for Local Exchange Carriers, First Report and Order, CC Docket No. 94-1, 77 R.R.2d 783, ¶ 92 (1995).

[128] Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, 9 FCC Rcd. 1687 ¶ 38 (1994).

[129] Id.

[130] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order,
(continued...)

to these baskets prior to clear evidence of substantial competition would allow the incumbent monopolists to undermine nascent competition. Certainly it is premature to combine the traffic-sensitive and trunking baskets.

Moreover, the elimination of service categories within the baskets will permit exactly the kind of cross-subsidization among services that the price cap regime was created in part to prevent. Absent a substantial competitive presence in each of the relevant markets, retention of service categories is necessary to limit improper subsidization. Otherwise, access services that have not yet been targeted by significant competitive efforts will likely experience rate increases that will, in turn, finance subsidies to other services that already are subject to competitive inroads. Until the ILEC has convincingly proven that competition can act as a substitute for regulation, service category distinctions are essential.

Finally, elimination of rate structure rules would allow the ILECS to evade any procompetitive reforms of rate levels and rate structures that the Commission adopts in this proceeding. If and when vigorous competition has firmly established itself in relevant markets in an ILEC's territory, these categorical distinctions may become unnecessary. In the interim, however, they continue to reduce cross-subsidization of competitive services by noncompetitive ones, and they constrain the ability of ILECs to leverage their local and exchange access market dominance into the long distance arena through subsidized bundles.

(...continued)
5 FCC Rcd. 6786 ¶ 198 (1990).

They also protect consumers and carriers dependent on these services from the payment of monopolized rates.

5. <u>Differential Pricing Across Customer Classes</u>. (<u>NPRM</u> ¶¶ 212-13) Finally, the Commission should also await the development of substantial, demonstrated competition before it allows ILECs greater flexibility to employ pricing schemes that differentiate across customer classes. Because competition will likely come to certain customer classes earlier than others, differential pricing would provide a mechanism for a noncompetitive class to subsidize a competitive one. For example, in many areas, multi-line businesses will probably receive the most interest initially from CLECs. Residential customers, particularly in nearby rural areas, will experience facilities based and perhaps even UNE competition much later -- if at all. Consequently, high access charges to residential customers could finance subsidized competition of business customers to the detriment of the CLECs and rural customers as well. This strategy may prove particularly lucrative if the ILEC can supply multi-line businesses with the full range of telephone services, including long distance. Absent pervasive and substantial competition, then, differential pricing will merely promote discrimination against carriers and consumers.

B. The Commission Should Initiate A Rulemaking To Establish Appropriate Metrics For Ascertaining When A Competitive Presence Sufficient To Relax Price Cap Disciplines Has Emerged.

Given the myriad anticompetitive effects and the inefficient usage and investment decisions that high access rates and insufficient regulatory constraints may perpetuate, the cost associated with premature deregulation of exchange access services obviously far outweighs any costs imposed by continued regulation. Indeed, even though AT&T faced significant competition in long distance markets and had been divested of its control over local and exchange access services, the Commission still took over a decade to declare AT&T a nondominant carrier and release it from a myriad of regulatory constraints. The ultimate decision to grant AT&T greater flexibility came only after substantial time and consideration of many factors including "considerations of market share, demand responsiveness, supply responsiveness, and AT&T's pricing behavior." NPRM ¶ 150.

The ILECs, by contrast, currently pose an enormous threat because they "control bottleneck facilities." Id. ¶ 150.[131] The ILECs' ability to leverage their exchange access and local market dominance into long distance, plus the increased incentives they have to engage in anticompetitive behavior under the transformations wrought by the Act, paint a complicated picture of cross-subsidization, market distortions, inefficient investment, and high consumer prices.

Accordingly, the Commission should proceed cautiously and initiate another rulemaking in which these difficult issues can be fully aired and with the benefit of a better delineated competitive landscape. It would be premature and irresponsible at this point to reach any conclusion about the criteria necessary to ascertain the existence of either a demonstrated competitive presence or substantial competition, except to note (as we have explained above) that the factors identified in the NPRM are plainly inadequate. The question

[131] For this reason, as the Commission has recognized, an inquiry "based solely on an incumbent LEC's market share" will be inadequate to determine that substantial competition exists. Id. ¶ 203.

of when and under what circumstances the incumbent ILECs should be given additional pricing flexibility is one of the most important policy issues in the entire telecommunications arena today. The Commission simply should not make such an important decision on the basis of an inadequate record.

If the Commission nevertheless finds that a metric for deregulation must be established in this proceeding, it should adopt a threshold that limits the potential injury to competition, new entrants, and consumers. Because the exchange access bottleneck is more prone to abuse than any other aspect of ILEC market dominance, it should have the highest threshold for deregulation, one substantially higher than that provided in § 271(b)(1). As demonstrated in Section III, only facilities-based competition -- to the extent that it emerges -- can provide a sufficient constraint on the ability of ILECs to charge supracompetitive access rates. That will undoubtedly take time to develop. But that is the only standard that the Commission could sensibly adopt in this proceeding.

CONCLUSION

For the reasons explained above, the Commission should adopt a policy of reinitializing price caps rather than a "market-based" approach to access charge regulation, decline to give the ILECs additional pricing flexibility until after genuine competition has been demonstrated, and adopt the other measures described above.

Respectfully submitted,

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APPENDIX A

AFFIDAVIT OF WILLIAM J. BAUMOL, JANUSZ A. ORDOVER, AND ROBERT D. WILLIG

1. Our names are William J. Baumol, Janusz A. Ordover, and Robert D. Willig. William J. Baumol is Director of the C.V. Starr Center for Applied Economics at New York University and Professor Emeritus at Princeton University. Janusz A. Ordover is Professor of Economics at New York University. Robert D. Willig is Professor of Economics and Public Affairs at Princeton University.

2. We submit this affidavit in response to the Federal Communication Commission's (the "Commission") December 24, 1996 Notice of Proposed Rulemaking in CC Docket No. 96-262, *Access Charge Reform* (the "NPRM"). In the NPRM, the Commission acknowledges both that the facilities used to provide local exchange and exchange access services are identical and that there is a consensus that current access rates exceed the economic cost of providing access. The Commission has proposed two methodological approaches to reforming access rates. The more traditional method -- the "regulatory approach" -- proposed by the Commission involves the prescription of forward-looking cost-based access rates through a series of adjustments to current price cap indices. Among other steps, the Commission proposes to reinitialize price caps so that they more accurately reflect the true economic costs of access. This approach appears to reflect the Commission's current belief that the markets for exchange access are not competitive and that regulatory intervention is necessary to lower rates towards costs. However, the Commission has alternatively proposed a "market-based approach" to access rate reform. This approach